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Case No. 80-2047

IN THE

Supreme Court of the United States

October Term, 1980

LEONARD KULICK, SIDNEY KULICK, HOWARD SHIRVAN and STANLEY SHIRVAN,

Appellants,

v.

DEPARTMENT OF REVENUE, STATE OF OREGON,

Appellee.

On Appeal from the Supreme Court of Oregon

REPLY TO MOTION TO DISMISS OR AFFIRM

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Preliminary Statement

This Reply Memorandum is submitted pursuant to Rule 16.5 of the Rules of the Supreme Court of the United States, in response to Appellee's motion to dismiss the appeal or to affirm the determination of the Supreme Court of the State of Oregon, pursuant to Rule 16.

ARGUMENT

Appellee urges that the issues presented by this case have already been decided by the United States Supreme Court, and cites, at p. 2 of its Motion to Dismiss or Affirm, three cases decided by this Court in support of such claim. We believe this case presents a different issue; and we believe the weight of other relevant authority indicates that this Court would reverse the determination of the Oregon Supreme Court in this case, after full consideration of the issues.

The case at bar deals with an income tax which the State of Oregon seeks to assess directly against nonresidents, based solely on the income of an Oregon corporation and irrespective of whether that income has been distributed to the nonresident shareholders of the corporation.

The tax on the Appellants herein is exacted because the corporation in which they own shares elected, for federal income tax purposes, to be treated as a small business corporation ("Subchapter S corporation") pursuant to Section 1371 *et seq.* of the Federal Internal Revenue Code. The Appellants consented to such federal election; but did not make such an election with respect to the taxing statutes of the State of Oregon. As the Oregon Supreme Court found (Appendix to Jurisdictional Statement ["App."] at p. 13a):

> "We doubt that the validity of the tax rests on the taxpayers' [Appellants'] election of 'Subchapter S' status, as the department [Appellee] contends, at least

> not in the sense that the act of election itself constitutes a 'contact' with Oregon or a voluntary submission to an otherwise questionable authority. Once the choice to be taxed under Subchapter S is made with respect to the federal Internal Revenue Code, Oregon automatically applies the tax treatment prescribed by ORS 316.127(5) and ORS 317.320, *supra* note 2, though of course a taxpayer can avoid this effect by foregoing the federal Subchapter S option. The state's authority does not hinge upon this 'consent.' "

The tax involved here is not being collected from the Oregon corporation over which Appellee would, concededly, have jurisdiction. Nor is the tax being withheld from dividends or earnings being paid out or distributed by an Oregon corporation, as was done by the State of Wisconsin in the cases cited by Appellee at p. 2 of its Motion. In those cases, the State of Wisconsin sought to collect a tax through the corporation over which it had jurisdiction, and not the nonresident shareholder. Implicit in the questions presented in those cases was the assumption that the state could not directly collect a tax from the nonresident shareholder on his dividend income.

The tax statute involved here seeks to obligate Appellants to pay taxes to Oregon based merely on the fact that they own shares of an Oregon corporation. Oregon seeks to reach outside its borders to compel Appellants to pay such tax. The measure of the tax is related to earnings of a corporation, and not to earnings of the Appellants or to dividends or distributions paid to them. The obligation of the Appellants to pay the tax is being imposed based only on their shareholder status and not on any privilege granted

to Appellants or on any contact Appellants had with the state.

The Oregon Supreme Court based its determination on the theory that, in the realm of "economic reality", there has been sufficient contacts between Appellants and the State of Oregon for the state to impose its tax on Appellants, because the Appellants earned income through the corporation which did business in Oregon.

The Oregon Supreme Court has stated that the issue is "the validity of the tax itself, when assessed directly against nonresident shareholders upon income derived through their corporation from Oregon sources." See App., p. 12a.

The Oregon Supreme Court did not rely on the cases relied on by Appellee, and held instead that (App. p. 13a):

> "We think, however, that if a state's legitimate fiscal reach in the federal system indeed is more a matter of economic realities than of formal technicalities, as the Supreme Court's opinions tell us, then the state has not overreached its authority here."

Appellants agree that the issue is whether the state has overreached its authority, by attempting to exercise taxing authority over nonresidents. The Oregon Supreme Court went on to state (at App. p. 14a):

> "The practical effect of the tax imposed here is identical as if it were imposed on the shareholder's [Appellants'] gains in the hands of the corporation, as plaintiffs [Appellants] concede it could be under *Wisconsin* v. *J. C. Penney Co., supra,* or by one of the 'jurisdictional' devices employed by other states. The

'fiscal relation' to the opportunities and benefits available in Oregon as an 'orderly, civilized society,' in the language of *J. C. Penney Co.*, is exactly the same.

The effective collection of an income tax from nonresident shareholders can give rise to different issues, but there is no need to anticipate them here. On the record and briefs before us, plaintiffs' [Appellants'] attack is directed at the tax itself, not at the enforcement of any resulting lien or debt, see *supra* note 1, and we express no view on the latter question. All we hold is that in demanding that shareholders of a closely held corporation instead of the corporation contribute to this state a tax on the financial gains derived from sources within the state, the state is not demanding the shareholders' property without the due process of law commanded by the 14th amendment."

If the Appellee's position is upheld, then a heretofore rejected principle of taxation will be established permitting a state to tax nonresidents on earnings of a domestic corporation, where such nonresidents have had no contact with the State and have not consented to being taxed.

The concept of a corporation as a separate entity is also being undermined when the state claims that its shareholders are enjoying the privilege of the corporation doing business in the state.

Conclusion

The Appellee's Motion to Dismiss or Affirm should be denied, and the United States Supreme Court should note its probable jurisdiction to hear the appeal in this case.

Respectfully submitted,

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